

Internal Revenue Service

memorandum

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date: MAY 26 1983

to: Jerry Moore
International Examiner

from: Robert E. Culbertson, Jr.
Chief, Branch 6

subject: [REDACTED] - Informal Technical Advice

This memorandum responds to your request for informal technical advice on issues within sections 881, 1249 and 1491 of the Code.

FACTS

For purposes of this memorandum, we understand the relevant facts to be as follows.

The partnership [REDACTED] (the "Partnership") is a U.S. partnership engaged in the business of the production and sale of natural gas. The Partnership interests were owned in equal shares by three individual partners, [REDACTED] [REDACTED] and [REDACTED].

In [REDACTED], the Partnership entered into a gas purchase contract with an unrelated party to sell gas produced by the Partnership. The contract has an initial term of [REDACTED] years. In the contract, the Partnership reserved the right to process the gas or to have such processing performed by a third party.

In [REDACTED], the Partnership solicited offers from third parties interested in acquiring the right to process the gas reserved in the contract. One of the parties interested in acquiring the processing right was [REDACTED]. [REDACTED] was the successful bidder for the gas processing right, and negotiations continued from [REDACTED] to [REDACTED] on the terms and conditions of the acquisition of the processing right.

On [REDACTED] the Partnership donated an undivided [REDACTED] interest in the gas processing right to [REDACTED]. On [REDACTED] the Partnership and [REDACTED] sold their combined [REDACTED] interest in the gas processing right to [REDACTED], a Cayman Islands corporation, on the installment basis for a total price of \$[REDACTED] accepting a

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\$[REDACTED] cash down payment and a promissory note for the balance. The note called for [REDACTED] installment payments from [REDACTED] to [REDACTED] of \$[REDACTED], \$[REDACTED] and \$[REDACTED] respectively, with interest at [REDACTED] % on the unpaid balance. The amounts received by the Partnership were reflected as long term capital gain on the respective partnership returns.

On [REDACTED], the same day [REDACTED] acquired the processing right from the Partnership and [REDACTED] executed an agreement with [REDACTED] to acquire the right, under the same terms and conditions [REDACTED] had previously negotiated with the Partnership. In essence, for the right to process gas for liquid hydrocarbons, [REDACTED] was to build a gas processing plant, pay [REDACTED] % of the total value of "process gas" based on a prevailing monthly "contract price" as specified, and to make "keep whole" payments for certain decreases in the value of the gas processed.

[REDACTED] received \$[REDACTED] in payments pursuant to the agreement with [REDACTED]. The agreement was in effect from [REDACTED] to [REDACTED], when the sales contract and processing agreement were terminated. [REDACTED] maintains that the payments received pursuant to the agreement are proceeds from the sale of a capital asset, and are not subject to U.S. taxation. [REDACTED] has not filed any U.S. returns nor paid any U.S. taxes on the amounts received. There was no withholding at source on the payments made to [REDACTED].

The [REDACTED] stock is owned as follows: [REDACTED] percent by the [REDACTED] which are foreign investment funds and [REDACTED] percent by a U.S. individual who is also the general manager for the U.S. partnership which is the successor of the Partnership. The [REDACTED] were created as an investment vehicle for excess life insurance premiums paid to the [REDACTED] on variable whole life non-participating policies issued on the lives of [REDACTED] and [REDACTED]. The [REDACTED] are wholly owned by [REDACTED]. The policies provide that the value of the [REDACTED] investment will be paid to the holders of the policies upon death of the insured. The assets of the [REDACTED] include [REDACTED] stock.

The holders of the policies are U.S. trusts established for the children of [REDACTED] and [REDACTED]. The trusts are both owners and beneficiaries of the policies. [REDACTED] is trustee for the trusts established for the children [REDACTED] and [REDACTED] is trustee for the trusts established for the children of [REDACTED].

ISSUES

I. Is the gain realized by the Partnership on the sale of the processing rights to [REDACTED] taxable as ordinary income under

section 1249?

II. Do any of the amounts received by [REDACTED] from [REDACTED] as consideration for the sale of the processing rights constitute gain described in section 881(a)(4) as to which a 30% tax is imposed?

III. Did the Partnership incur an excise tax under section 1491 as a result of the sale of the processing rights to [REDACTED]?

DISCUSSION

I. Section 1249. Is Gain on the Partnership's Sale of Gas Processing Rights to [REDACTED] Taxable as Ordinary Income Under Section 1249 of the Code?

Section 1249 treats as ordinary income gain from the sale by a U.S. person of "a patent, an invention, model or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right" to a foreign corporation controlled by it within the meaning of section 1249(b).

We do not believe there is a strong argument that the contractual gas processing right sold by the Partnership to [REDACTED] is within the scope of intangibles listed in section 1249. The gas processing right is not sufficiently similar to the types of intangible property listed in the statute to argue forcefully that the statute on its face includes such a right. Each of the intangibles listed in the statute resulted from some creative or development process involving substantial individual services which is distinguishable from the contractual right to process gas at issue here. The legislative history gives no indication that such contract rights were within the intendment of section 1249. Moreover, we have been unable to locate any other authority which would help support the proposition that section 1249 applies to the gas processing rights. Because of the lack of authority, we do not believe there is strong support for the argument that the processing right sold by the Partnership is within the scope of section 1249.

II. Section 881. Are the Proceeds Received by [REDACTED] from [REDACTED] from the Sale of the Gas Processing Rights Subject to U.S. Tax Under Section 881 of the Code?

Section 881(a)(4) imposes a tax of 30 percent of the amount received by a foreign corporation from U.S. sources as gains from the sale of "patents, copyrights,, secret processes and formulas, goodwill, trademarks, trade brands, franchises and other like property," to the extent the gains are from payments that are contingent and are not effectively connected with a U.S.

business.

We believe an argument can be made that the contractual right to process gas sold by [REDACTED] to [REDACTED] constitutes "like property" similar to a franchise for purposes of applying section 881(a)(4). The statutory language clearly includes within the scope of section 881(a)(4) property rights similar to those specifically listed. Franchises and contract rights are listed together in section 936(h)(iv) indicating that Congress viewed such rights as similar in enacting section 936. A franchise is a type of contractual right to market a company's goods or services in a particular territory.

Thus, we believe that the processing right at issue in this case is sufficiently similar to a franchise to argue that the statute on its face applies to the gas processing right. Because the payments from [REDACTED] to [REDACTED] satisfy the contingency requirement and are not effectively connected to a U.S. business, we believe that the payments are subject to tax under section 881(a)(4) and that withholding is required under section 1442. The full 30 percent rate of tax imposed by section 881 would apply since there is no tax treaty between the United States and the Cayman Islands reducing the tax.

III. Section 1491. Is the Partnership Subject to an Excise Tax Under Section 1491 of the Code on the Transfer of the Processing Rights to [REDACTED]?

Section 1491 imposes an excise tax on the transfer of property by U.S. persons to a foreign corporation as paid-in-surplus or as a contribution to capital. The amount of the excise tax is 35 percent of the excess of the fair market value of the property transferred over the transferor's basis in the property plus the amount of gain recognized to the transferor at the time of the transfer.

We believe there is a strong argument that the transfer of the processing right by the Partnership to [REDACTED] assuming the sale was at less than fair market value,¹ constituted a capital contribution (in the amount of the bargain element) by the Partnership to [REDACTED] subject to the excise tax imposed by section 1491.

Although the Partnership is not a shareholder of [REDACTED], the transfer of the processing right at less than its fair market value may nevertheless constitute a contribution

¹ Although the fair market value of the processing right sold to [REDACTED] is at issue, we assume for purposes of this memorandum that the right was sold for less than its fair market value.

to the corporation's capital for purposes of section 1491.² The Supreme Court set forth the test for non-shareholder contributions to capital in United States v. Chicago, B&O R.R. Co., 412 U.S. 401 (1973). That case set forth the following standards. The transfer may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. It must be bargained for. The amount transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value. The asset ordinarily will contribute to the production of additional income to the transferee. The Supreme Court rejected looking at the intent of the transferor in determining whether there has been a non-shareholder contribution to capital.

Thus, the test set forth by the Supreme Court looks at whether the transfer, as long as not payment for a specific service, benefits the transferee and becomes part of the transferee's working capital structure. Applying the Court's test in this case, it is clear the payments were not payments for specific quantifiable services performed by [REDACTED] for the Partnership. Further, it is clear [REDACTED] benefitted in the amount representing the difference between the price paid to the Partnership for the processing rights and the fair market value of those rights. The transaction in this case thus satisfies the standards set forth by the Supreme Court for a non-shareholder contribution to capital. As a result, the transfer by the Partnership to [REDACTED] as a contribution to capital is subject to the section 1491 excise tax.

Although the excise tax would not apply if the transfer is not in pursuance of a plan principally to avoid tax, the discussion of this issue on page 8 of Form 886-A would be relevant here. Although [REDACTED] technically is owned by the [REDACTED], the facts would show the direct relationship between the trusts' assets and the stock of [REDACTED] and ultimately the flow of cash to the beneficial owners of the trusts. Such a relationship, in addition to the non arm's-length purchase and almost simultaneous resale of the gas processing rights in this case, should be sufficient to support an argument that the plan

² Note that although there may be a "relationship" of some kind between the Partnership and the owner of the [REDACTED] stock and between the assets of [REDACTED] and the trusts which may be relevant in establishing the non arm's-length nature of the transaction, that relationship would not change the fact that the Partnership is not a shareholder of [REDACTED]. In this regard, common law principles would control in determining shareholder status since no statutory attribution rules apply; under those principles, there is no good argument that the Partnership owns the stock of [REDACTED].

was to avoid tax. Nevertheless, the issue of tax avoidance purpose is a question of fact which could partially depend upon whether the fair market value of the processing rights exceeded the price paid for those rights by [REDACTED]

We do not believe section 367 could apply to the facts of this case. In order for section 367 to apply in this case, there must be a tax free exchange satisfying the requirements of section 351 which, in this case, would require that the Partnership immediately after the transfer own [REDACTED] percent of the stock of [REDACTED]. This requires direct ownership of stock and that ownership cannot be established by attribution or by common law principles of effective control. In addition, even if the transaction were treated as if the Partnership received stock in exchange for the capital contribution, which is unlikely since the Partnership was not a shareholder of and did not control [REDACTED] before the "exchange", the Partnership would not satisfy the control requirement of section 351 since the Partnership did not retain stock of [REDACTED] immediately following the "exchange".

Finally, as to the amount of the transfer subject to the excise tax, although there may be an argument to the contrary,³ we believe the stronger argument to be that the excise tax applies only to the amount of the transfer treated as a capital contribution. In this regard, the Senate Committee Report on P.L. 94-455, indicates that the rule for applying the excise tax to corporations differs from that applicable to other entities and applies only to the amount of the transfer treated as a capital contribution -- in this case, the excess of the fair market value of the processing rights transferred over the purchase price paid by [REDACTED] for the processing rights.

CONCLUSION

The arguments made in this memorandum respect the form of

³ We considered the following arguments but concluded that neither was clearly supportable:

(1) Section 1491 refers to transfers to foreign corporations as capital contributions and not to the amount treated as a capital contribution; thus the total amount of the transfer is subject to the excise tax.

(2) The entire fair market value of the property transferred to the corporation should be treated as a capital contribution and thus subject to the excise tax. The approximately [REDACTED] dollars received by the Partnership would be treated as dividends.

the transaction as engaged in by the taxpayer in this case. There are several substance over form arguments which can be made if the taxpayer chooses to challenge the form of the transaction.